Indonesia's Economic Recovery Remains on Track

Summary:

- Indonesia's economy continues to recover from the impact of August 2005 rupiah "mini-crisis," with growth in gross domestic product (GDP) reaching 5.5% year-on-year (YoY) in the third quarter.
- Strong external demand for Indonesian commodities and increased household consumption supported the more robust growth rate.
- In contrast to the previous quarter, however, growth in government expenditures slowed significantly during the July to September period, due in part to decentralization which, according to many analysts, has disrupted the dispersal of government funds.
- While the investment outlook in Indonesia has improved somewhat, fixed capital investment remained stalled in the third quarter, contracting over the same period last year.
- Analysts expect domestic demand to continue to accelerate through the end of 2006 and through the first half of 2007 supporting more robust GDP growth.
- Indonesia's overall macroeconomic outlook continues to improve with lower inflation expectations, rising foreign exchange reserves, and a less volatile exchange rate.
- A significant contraction in global demand, a sudden change in foreign short-term investor sentiment, delays in pro-investment reforms, and the failure to reduce unemployment levels are the key risks to economic growth and stability over the short-to-medium term.

Table 1: Real GDP Growth, 2005-2006, Year-on-Year

	2005 Q4	2006 Q1	2006 Q2	2006 Q3
Private consumption	4.2	3.2	3.0	3.0
Government consumption	30.0	14.2	31.6	1.8
Fixed capital formation	1.8	2.9	-1.0	-0.3
Exports of goods and services	7.4	10.8	11.3	12.1
Imports of goods and services	3.7	5.0	8.3	9.7
GDP	**4.9**	**4.6**	**5.2**	**5.5**

Source: Central Bureau of Statistics

Indonesia Reports Higher GDP Growth in Third Quarter

Private consumption, which comprises the largest component of GDP at over 60%, continued to recover modestly in third quarter of 2006, growing 3.0% YoY as the affects of lower inflation and reduced interest rates began to take hold among individual consumers. Headline inflation dropped to 6.3% YoY in October, due to the significant increase in the inflation base caused by the October 2005 fuel price hikes. In response to lower price levels, Bank Indonesia (BI) loosened monetary policy further in November, reducing the BI policy rate (reference interest rate) by 50 basis points on November 7 to 10.25%. According to BI, demand for loans began to improve significantly during the third quarter, with domestic credit increasing by Rp 18.5 trillion (US$ 2.0 billion) during the month of September, the highest monthly increase this year. Observers expect private domestic demand to improve further in the near term, as more stable price levels and lower interest rates encourage private sector spending and the Government of Indonesia (GOI) implements planned wage increases for civil servants.

Strong external demand for Indonesian commodities resulted in robust net export growth during the third quarter. Exports of goods and services rose 12.1% YoY, continuing the trend of strong growth during the first half of 2006. Indonesia's commodity exports have been very strong during the first nine months of 2006, with exports of coal, rubber and rubber goods, and crude palm oil growing 44, 71, and 17 percent respectively YoY. Growth in imported goods and services failed to keep pace, increasing only 9.7% YoY in the July to September period. Looking ahead, most observers expect local demand for imports to increase in subsequent quarters in line with resurging private demand, and global demand for Indonesian commodities to decline in proportion to slower world growth. While most analysts expect the economic impact of these trends to be moderate, a sharper than anticipated contraction in net exports would slow growth and put pressure on Indonesia's balance of payments.

Government Spending and Investment Flat

Surprisingly, given that government expenditures traditionally increase during the second half of the year, YoY growth in government expenditures stagnated in the third quarter, rising only 1.8%. Analysts attributed the slowdown in spending to the more rapid than expected disbursement of funds in the second quarter as well as ongoing difficulties facing the disbursement of funds at the local level. The GOI plans to significantly increase spending in the fourth quarter of 2006, likely boosting growth through the end of the year. However, the GOI has announced a reduction in overall spending in 2007 as a share of GDP, and observers expect problems associated with disbursement at the local government level to persist over the short-to-medium term, limiting the government's ability to stimulate economic growth.

Indonesia's economy continues to suffer from very low levels of investment, with fixed capital formation contracting 0.3% YoY in the third quarter. The low investment numbers reveal that GOI policies aimed at encouraging investment have so far produced only limited results. Looking ahead, however, analysts believe the anticipated pick up in domestic private consumption will provide some stimulus to investment over the next six to nine months. According to data collect by BI, domestic investment approvals have almost tripled during the first eight months of 2006 compared to the same period a year earlier, and foreign investment approvals are up 20% over the same period. In addition, the November 1-3 Infrastructure Forum helped reignite investor interest in large-scale infrastructure projects in Indonesia, particularly in the power sector. A key question will be the speed at which the GOI or Parliament completes work on important legislation impacting on the investment climate, including draft investment, tax, and labor laws. Absent continued progress on these issues, investors may become skeptical of Indonesia's ability to maintain a competitive investment climate compared to its competitors in the region.

Indonesia's cumulative GDP growth rate for the first three quarters of 2006 was 5.1%, a rate generally in line with economists' forecasts. Although the economy grew at a more robust pace in the third quarter, most analysts believe it is unlikely to meet the GOI's target 5.8% growth rate for the full year. The transportation and telecommunications sector, growing at a cumulative rate of 12.8% during the first three quarters of 2006, continues to outperform other segments of the economy. Manufacturing growth slightly accelerated in the third quarter but the sector's growth rate, at 4.1% year to date in 2006, is still below that of the economy as a whole. Growth in the agriculture and mining sectors remain lackluster. Agriculture and mining production have expanded 3.4% and 2.3% year to date in 2006, respectively.

Prudent Macro Policies Expected, But Risks Remain

Most economic observers expect the GOI and BI to continue to pursue prudent monetary and fiscal policies over the next several quarters. These policies have stabilized the rupiah, lowered inflation expectations, and contributed to the significant accumulation of foreign exchange reserves in 2006. The GOI has limited spending in 2006 and expects to further reduce spending levels during 2007 in order to reduce Indonesia's external debt level and enhance investor confidence. In its November 7 statement announcing the lowering of the BI rate to 10.25%, BI cited "economic concerns calling for vigilance in the months ahead" including continued inflationary pressure in 2007. BI added that "the Board of Governors...sees the need for more measured, cautious operation of monetary policy to maintain macroeconomic stability in the medium and long-term and consolidate the momentum for sustainable economic recovery." Despite these cautious words, some analysts have voiced concerns that in its efforts to support growth, BI will lower interest rates too quickly or too far, leading to renewed inflation and/or rupiah volatility.

Most analysts agree that the biggest risks to continued economic growth and stability in Indonesia in the short term are negative external developments. A sharp drop in global demand for Indonesian products, especially commodities that have provided significant support for GDP growth in recent months, or a shift in foreign portfolio investor sentiment away from Indonesia could put renewed pressure on Indonesia's balance of payments and undermine Indonesia's hard-won macroeconomic stability. However, continued strong growth in the region, particularly in China, is expect to at least partially offset an anticipated slowdown in the economic growth in the United States. Longer term risks to Indonesia's economic outlook include the slow pace of infrastructure investment and the relatively slow growth in labor intensive sectors like garments, footwear, and electronics. New investment in infrastructure projects is particularly important given that much of country's electricity grid, road system, and ports are already operating at maximum capacity and the quality of those facilities has eroded substantially over time.